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German Economic Governance and the Eurozone: Misguided Leadership?[[1]](#footnote-1)

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 DRAFT

*Introduction*

The Eurozone crisis is more than the sum of the economic crises of some of its member economies. It is simultaneously a crisis of the institutional setting of the Eurozone, as well as of its underlying economic-political architecture and mode of regulation. Moreover, the Eurozone crisis fundamentally reshaped power relations between its members in ways that will affect not only the Eurozone but also the overall project of European Integration. For the crisis transformed a post-hegemonic project, where all members have equal rights and obligations practically overnight into one of a hierarchical club that required political and economic *leadership* from a few leading countries. For a while it seemed that a particular incarnation of the French-German axis – effectively *Merkozy* – would successfully manage the crisis. However, rather than designing a coherent crisis strategy, the *Merkozy* axis was only able to come up with weak bilateral policy compromises that failed to end the crisis. The more the crisis was prolonged, the more it became clear that the political space of the Eurozone started showing cracks. The electoral victory of Syriza in Greek elections in 2015 highlighted this political division, at least to some degree. With the French-German motor stuttering, Germany emerged as the key actor and, more importantly, the key creditor in the increasingly salient *creditor – debtor- axis* that came to dominate the further unfolding of events. Yesterday’s poster-child of ‘Eurosclerosis’ was all of a sudden in strong demand as a key crisis manager of sorts. Has the Eurozone turned into a Germany-zone?

A prominent chorus of critics complains that a new German dominance has emerged in Europe to fundamentally change the principles of the European integration project[[2]](#footnote-2). In contrast, I argue that the German government has not changed its overall policy approach towards Europe at all. It has always acted in Europe from a domestically deeply entrenched policy path and continues to do so. Moreover, contrary to assertions of Germany ‘hegemony’ in Europe, I note that, rather than providing a coherent ‘regional public good’ in a hegemonic manner, Germany acts like a dominant leader that uses its power to shape agendas and to veto alternative strategies in order to safe the Eurozone. Paradoxically, Germany’s deeply path dependent actions were critical for driving the Eurozone ever deeper into a political and economic configuration that ultimately risks the sustainability of the Eurozone in its current form[[3]](#footnote-3). The result could be a Eurozone stuck in a situation of low growth, high unemployment, deflation/’disflation’, and political division that may result in a shrinking of the Eurozone.

*Looking Back*

In the course of the Eurozone crisis Germany has not emerged as a regional hegemon in Europe that takes interests of creditors as well as of debtors into consideration but rather as a dominant power guided by narrowly defined national preferences. Crisis management in the Eurozone so far has mainly been a story of struggles between member states in the European Council, rather than one of the European Commission implementing mutually beneficial solutions. [[4]](#footnote-4). Intergovernmentalism is back in a strong way (Schimmelfennig 2015). Rather then further analyzing this return of intergovernmentalism, this article focuses on the national preferences of Germany in times of crisis. I will argue that Germany is not operating with a master plan but follows a form of social engineering where national preferences in regards to (i) fiscal sober-mindedness, (ii) containment of moral hazard, (iii) avoidance of an immediate breakdown of the Eurozone, and (iv) improving international competitiveness have been the key objectives of the chosen strategy.

The Council’s surprisingly strong capacity to make changes to the institutional architecture and economic governance of the Eurozone has been harnessed by the German government to renovate the mode of regulation of the Eurozone according to its overarching preferences. This was possible because other members of the creditor camp in the EU shared Germany’s core preferences. ‘Leopard politics’ is the best way to describe the German policy approach:’ *If we want things to stay as they are, things will have to change’.* After a slow start the Merkel governments were willing to change the mode of economic governance in order to safeguard the underlying principles of the Eurozone that were already put in place during the design and launch period of the Euro As will be demonstrated, at the outset of the common currency project German governments successfully established the basic structural principles that favor austerity and wage- compression in times of crises. These principles reflect long-standing attitudes and political values of *Modell Deutschland* that are shared by nearly all political parties and actors (see below). These renovations have inherent economic as well as political limits, though. In addition to the widely noted costs these renovations are exacting, they have additionally created an ‘institutional civil war’ about the current and future role of the European Central Bank (ECB). Again, it is Germany that plays a critical role in contesting the actions from Frankfurt. Reviewing previous episodes of contestation demonstrate the similarities of action then and now and also hint to the main difference of Germany’s action today.

The current Eurozone crisis is only the latest in the long history of currency crises that have afflicted EU member states since the beginning of currency cooperation in Europe after WWII. Its start can be dated in earnest with the breakdown of the fixed exchange rate of Bretton Woods in 1971/73. This is when the US unilaterally relinquished the system of fixed gold parity to the US-Dollar (USD), and eventually dissolved the regime of fixed exchange rates. While other OECD-economies went along with this, France and Germany jointly decided to create a zone of currency stability in Europe so as to free themselves from the currency policy of the US, which they saw as guided by narrow national interests. The first step in this new venture, the ‘Snake in the Tunnel’, pegged national monies to each other in order to avoid strong exchange rate swings that could endanger their close-knit trade relations. The ‘snake’ was a classic example of joint French-German leadership in the EU with both actors agreeing to produce a collective good at their cost, and where the other members behaved as policy-followers. In the language of the original Kindlebergian hegemonic theory, France and Germany showed (i) the willingness to act as regional leaders; (ii) the economic and political capacity to lead and to produce regional public goods; and (iii) the ability to inspire sufficient followership.

The quickly revealed weaknesses of this improvised device led Germany and France to develop a more comprehensive and formal institutional framework for currency cooperation. The 1979 European Monetary System (EMS) was a fixed exchange rate regime that permitted currencies to fluctuate within even narrower bands. It resembled the Bretton Woods fixed exchange rate regime that also permitted joint realignments of exchange rates in case of external disturbances or asymmetric shocks. Unlike the regime of Bretton Woods, however, the EMS had no key currency nor did gold play a role. As a truly fiat currency regime its proper functioning depended on the smooth reproduction of national economies and the cooperation of national central banks. Moreover, France and Germany at the time were able and willing to push a project that was attractive for others, and thus all prominent member states except the UK joined the ERM[[5]](#footnote-5).

McNamara (1998) observed that the EMS reflected the neoliberal *Zeitgeist*,moving from ‘embedded liberalism’ to ‘competitive liberalism’[[6]](#footnote-6). The EMS did not just isolate its zone from the effects of ‘outside’, particularly US, economic policies, creating a zone of stability where exchange rates were managed via rule-based central bank interventions. It also simultaneously pushed for the further liberalization of financial markets in line with the overarching political project to establish a market-driven growth regime in Europe. The creation of a currency zone of politically controlled stability came with a further liberalization of national capital accounts that opened up opportunities for the newly consolidated financial industries across Western Europe (Gehringer 2013). Even though the liberalization approach was modest in comparison to the US and to the UK it started to give political voice to financial market actors who got market-driven supervision in order to ensure sound fiscal policies. The founders of the EMS soon had to learn the lesson that a regime of fixed exchange rates and open financial markets cannot simultaneously enjoy both fiscal policy autonomy and monetary independence.

The first open crisis started in 1981. Differing trajectories of national growth as well as differing national political projects created problems for the EMS as demonstrated, preeminently, by the French Socialist-Communist government of President Mitterrand. Its economic policy program frightened national as well as international investors with its emphasis on nationalization, Keynesian demand policies and the shortening of working hours (Altvater/Hübner/Stanger 1982). Due to capital flight the Franc was coming under pressure, particularly in relation to the Deutschmark that was stabilized by the strict anti-inflationary policy of the German Bundesbank. Increasing capital flight put the newly launched exchange rate mechanism under immediate adjustment pressure. When President Mitterrand accepted three devaluations in quick succession, it was obvious that his economic policy program was not viable, and a turn towards a German-inspired *Franc fort* was chosen as new policy route (Lee 2004). The French government had to give up most of its reform plans and turn away from its Keynesian approach as well as from further nationalizations. From there on the currency zone mutated quickly into a Deutschmark zone where the Bundesbank became the agenda setter and the other member states became policy followers. In a constellation of open financial markets and differences in national inflation rates, it was the interest rate policy of the economy with the lowest inflation rate that acted as stability anchor[[7]](#footnote-7). The inflation ‘hawks’ of the Deutsche Bundesbank had long kept German inflation below the European average through the ruthless use of the key lending rate and now, if politically detrimental costs of devaluation were to be avoided, other national central banks, in particular the Banque de France, had to follow the leader.

The imposition of German national preferences on the rest became even more obvious in the early 1990s. Concerned about the inflationary effects of the debt-financed process of German unification and the so-called ‘unification boom’, the Deutsche Bundesbank used its autonomy in setting the key lending rate to signal to the German government that it would not be willing to accept an increase in the inflation rate. In July 1992 the Bundesbank raised its discount rate to a new post WWII record of 8.75%; at the same time as the US-Federal Reserve, as well as the Bank of Japan decreased their key lending rates in order to fight emerging recessions. The result of these opposing interest rate movements led to speculative attacks on the weak members of the EMS, mainly Italy and the UK. Rather than dealing with these attacks by reversing its high interest rate approach, the Bundesbank focused solely on its domestic price stability target. This lack of ‘Europeanness’ came with high costs, as the EMS was more or less dismantled in the aftermath: The UK left the EMS and the exchange rate band had to be widened significantly (Herr/Hübner 2005: 208ff.). Again it was that Bundesbank that acted solely along its national preferences.

Though the project of a common currency was first mooted in Werner-Report of 1967, it is best seen as a reaction to these later episodes of exchange rate volatility. It came to be realized in the form of a deliberate attempt of some European governments to domesticate the Bundesbank, by creating a level playing field for all central banks. It was led by the French government that also wanted to ensure that the newly united Germany would not overwhelm Europe and thus undermine the hard achieved economic-political power balance. Thus it was that the Euro was given a governance structure that formally made each participating central bank an equal member. However, the Bundesbank and the German government used their agenda setting capability to transform the new European Central Bank into an ‘über-Bundesbank’. Not only was the ECB, like the Bundesbank, mandated to focus solely on price stability, membership of the Eurozone was predicated on compliance with the Maastricht criteria, also more oriented towards price stability than on other economic indicators. In the first years of the Eurozone the interest rate set by the ECB turned out to be too high for slow-growing Germany and too low for fast-growing economies like Ireland and some southern members of the Eurozone. The result was a divergence in national inflation rates that had severe repercussions for the real effective exchange rate, and thus for the real interest rates. As a result economies with higher than average inflation rates experienced appreciations in their real effective exchange rates, and therefore a deterioration of price competitiveness. Low or even negative real interest rates in some national economies were an incentive for private sector actors to make use of this opportunity and to drastically increase their demand for cheap credits. The combination of a unified monetary space, national economies with national fiscal policy autonomy and liberalized capital markets without a Eurozone-wide supervision exacerbated economic divergence in the Eurozone (Hübner 2013).

Given this historical background, the current political debate about a *new* ‘German Empire’ is misleading. The German government is not using the Eurozone crisis to eventually push through a fundamental restructuring of the Eurozone along German national interests simply because the Eurozone was already structured in this manner. This was reflected in the so-called ‘Maastricht Criteria’ where fiscal stability figured prominently as well as in the German-driven Stability and Growth Pact. The Merkel government’s policies towards fiscal constraint and austerity thus represent *continuity* not change. Germany provides financial support in exchange for far-reaching policy domestic changes in crisis economies in order to converge towards the Swabian Housewife approach of Germany. In contrast to the episodes of the ‘Snake’ and the EMS it is no longer the Bundesbank that masterminds adjustments to German national preferences. This is now being driven by German-inspired forms of governance and interventions at then level of the Council.

*The Logic of National Preferences*

The Eurozone crisis and the crises of member economies triggered some heated political and academic debates about causes and solutions. The highly visible exercise of German agenda-setting and veto power led a number of scholars and public alike to identify Germany as the new culprit of European politics. More careful analyses identify Germany as a ‘reluctant hegemon’ (Paterson 2011) who was moved front and center to the crisis management, not least due to its relative economic strength. The weakening of the French-German axis (Schild 2013) and the relative loss of France’s economic position pushed Germany’s leadership role even further.

Closest to my interpretation of Germany’s strategy is the attempt of Bulmer/Paterson (2013) who base their analysis on various strands of hegemonic theories. However, the attempt to portray Germany as a ‘reluctant hegemon” misses to discuss the possibility that Germany’s economic strategy may be not the solution but may add to the problems of economic governance, and thus the possibility that Germany actually is a unwilling hegemon. While there is no doubt that the demand for leadership in the Eurozone increased and, supply being scarce, German governments filled the void, it is also clear that German actions were propelled by Germany’s high stakes in the Eurozone, making German elites ready to develop and fight for a crisis management that avoids the breakdown of the Eurozone and at the same time re-designed the economic governance in line with German preferences. Like Bulmer/Paterson (2013), I ground my analysis on a ‘Kindlebergian’ version of a hegemonic stability approach that understands hegemony as an action of a nation-state to produce and finance a public good. The hegemon is producing and maintaining such a public good by taking into account interests of all actors. My argument points out that the new institutions that were created or suggested during the crisis management period 2010 to 2014 rooted in Germany’s dominating stability paradigm and reflect German interests more than any aim to produce regional public goods. Rather then being a ‘reluctant hegemon’ Germany is an ‘unwilling hegemon’.

In contrast to other member states of the Eurozone, Germany’s political economy shows an enormously high level of political homogeneity. Any existing deep party divisions between Germany’s political actors do not extend to the project of European integration and the common currency zone: European integration is a non-contested arena in German politics. Since programmatic statements of relevant German political parties are not synonymous with actual policies, I did a preliminary content analysis of German newspapers and weekly papers in regards to statements on the Eurozone crises[[8]](#footnote-8). The political parties were analyzed in regards to six generally sticky policy elements: (i) attitude towards strengthening the criteria and supervision of the Stability and Growth Pact; (ii) position on the Fiscal Pact; (iii) stance regarding the specific Debt Brake policy (iv) attitude towards the austerity approach; (v) opinion on the Outright Monetary Transaction policy of the ECB; (vi) attitude towards all versions of Eurobonds.

*Table1: Attitudes of German Political Parties Towards Eurozone Crisis[[9]](#footnote-9)*

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **Strengthening SGP** | **Fiscal Pact** | **Debt Brake** | **Austerity** | **OMT** | **‘Eurobonds’** |
| **CDU/CSU** | +3 | +3 | +3 | +3 | -3 | -3 |
| **SPD** | +3 | +3 | +3 | -2 | +2 | +3 |
| **FDP** | +3 | +3 | +3 | +3 | -3 | -3 |
| **Green Party** | +3 | +3 | 0 | 0 | -1 | 1 |
| **Linke** | -3 | -3 | -3 | -3 | -1 | +3 |

From ‘+3 in strong favor to -3: strong rejection’

This admittedly unsophisticated exercise yielded clear results. First, the party preferences along critical policy issues show that the CDU/CSU has the most coherent policy preferences. The two sister parties agree strongly in a policy that strengthens the SGP, favors the Fiscal Pact and the debt brake, and supports strongly the unifying austerity approach. Consequently, both parties vehemently reject the bond purchase policy of the ECB and radically oppose any form of Eurobonds. Their previous coalition partner, the Free Democrats (FDP), express exactly the same preferences. This makes the previous governing party camp to a very homogenous grouping that was able able to weather minor differences.

The Social-Democratic Party (SPD) has long supported, launched and implemented various projects of European currency cooperation, including the underlying political and economic forms of governance. During the crisis it favored strengthening the SGP, introducing the Fiscal Pact and even the debt brake. At the same time, it has slowly but surely moved towards a critical stance on the austerity approach and became a relatively strong supporter of the OMT of the ECB and forms of Eurobonds. Since entering a coalition government with the CDU/CSU in 2013, its preference for Eurobonds disappeared and so has its critical stance towards austerity, with the party supported all policies of the conservative coalition leaders. Differences with the conservative parties are in nuances not in substance.

The Green Party is in an only slightly better position. In order to demonstrate political respectability, which effectively means accepting fiscal conservatism, the Greens willingly gave parliamentary support for the government’s crisis management decisions. Rather than presenting a policy project that would reflect coherent alternative policy proposals, the party opted for a dual approach: supporting the government while paying lip service to alternative discourses.

Die Linke presents the overall most coherent distribution of preferences in the opposition camp. This party strongly opposes all elements that constitute the austerity approach, and consequently favors forms of Eurobonds. Simultaneously, it sees the ECB as a neoliberal institution and thus rejects the active role of the ECB in managing the crisis[[10]](#footnote-10). In the context of the crisis, her critical stance towards the ECB ironically aligns the party with Euroskeptics.

It is this overall united domestic front that greatly strengthens the hand of any German government in European crisis management. Moreover, the overall high homogeneity contrasts starkly with the deep political and ideological divisions that characterize many other Eurozone societies.

*From the French-German Axis to a Multitude of Temporary Alliances*

The literature usually treats France and Germany as the political axis of European integration. Their agenda setting power and ability to create consensus by offering acceptable compromises for other partners, as well as their well-demonstrated ability to jointly design policies that help overcome crises historically, was critical for the ongoing processes of European integration (Krotz/Schild 2013). France and Germany came to this form of cooperation from different angles, however, and with rather different political and economic resource bases. The theory of cooperative hegemony portrays Germany defensively seeking overall stability and political-moral rehabilitation, while also securing the long-term benefits of European integration in the 1950s in accordance with a strong domestic consensus. The suggestion that Germany moved in the late 1970s from a strategy of defensive cooperative hegemony to one of offensive cooperative hegemony where Germany started to push for its own interest (Pedersen 2002: 686) seems to me not convincing. I have tried to show that Germany as well as France moved jointly in an economic, as well as political balance, cooperating on various projects of currency collaboration after the end of Bretton Woods in 1971. External crisis pressure forced both entities to the closer cooperation of equals. It is only with the Eurozone crisis that such a cooperation of equals has lost its ground.

France and Germany had different policy responses to the crises, and were increasingly having difficulties finding mutual compromises, not to speak about broader compromises that once received wide support in the European Council. There is no doubt that Germany as well as France share the intention to keep the Euro intact. Strategies and proposed economic policies to achieve these goals differed in substantial ways however. Still, between October 2010 and summer 2012 the German and French governments pushed for the German project of a ‘Fiscal Pact’ and mainly agreed on further changes in economic governance. However, this cooperation showed diminishing economic as well as political returns for France. In particular, the German policy emphasis on improving competitiveness by reducing direct and indirect wages is seen in France with suspicion. Even though France and Germany continued to cooperate, the terms of cooperation turned in favor of German interests and preferences. This was obvious when German Chancellor Merkel and French President Hollande eventually presented a joint paper on the planned banking union that was supposed to cut the ties between banking crises and sovereign debt crises. To be effective such a banking union needed to come with a single supervisory body, an adequately funded single resolution body and a joint deposit-insurance program. All those features, though, were in fundamental contradiction to German principles. As a result, the eventual banking union did not include a jointly financed rescue fund neither a joint deposit insurance scheme. Following German wishes, banking risks are now first dealt with inside the nation-state; moreover, all attempts to install first elements of risks sharing across the Eurozone were suspended - a further indication that Germany is increasingly shaping the institutional reconstruction of the Eurozone along its national preferences.

France’s mounting domestic economic problems serve to add to the discontent. The widening gap in French and German economic fortunes is best exemplified by their respective current accounts. France ran deficits over the whole period from 2006 to 2012, while Germany ran very high surpluses. France has long-standing competitiveness problems: poor price competitiveness and difficulties with staying in the mid-segment of the technology race (Baudchon 2013)[[11]](#footnote-11), while Germany’s export sectors remained attractive for emerging market economies. This divergent trade performance was critical in the crisis when German companies were able to drastically improve their export position with the BRIC economies, whereas France was stuck in a deficit (see Graph 1). Due to its export portfolio that is strong in capital goods as well as in high-end consumer goods, the German export sectors were successfully finding alternative export outlets in times of shrinking EU-markets. By this, Germany, unlike France that showed a relatively stronger orientation towards EU-markets, was able to benefit from the growth spurt of the BRICs.

Graph 1

Data: Eurostat. Graph prepared by Jeff Mitchell

With public deficits remaining high, France had to enter the Excessive Deficit Procedure of the EU in 2012; in contrast, Germany enjoyed increased tax receipts that help to bring down its annual budget deficit, and even could register a small surplus of .2% of its GDP in 2012 (Eurostat 2013)[[12]](#footnote-12).

These differences have second-order policy implications. In order to improve its trade balance, France is eager to provide the troubled economies of the Eurozone purchasing power, and thus favors growth-stimulating policies as an integral part of European crisis management. Rather then sticking to debt limits the French government is in favor of growth-stimulation, not only by France but in particular by Germany that has ample fiscal space. Germany on the other side sees any form of demand increasing policies coming with increasing budget deficits and thus increasing debt that consequentially lead to steep increases in national risk premiums. Latter are seen as potentially aggravating the debt situation and thus potentially demanding expensive rescue operations that may result in huge fiscal transfers from Germany that could potentially subvert Germany’s enviable financial position. Rather then opting for growth-stimulation, Germany favors domestic supply side structural reforms across the Eurozone.

Germany’s comfortable situation is evident in comparison to the current accounts and public debt ratios across the Eurozone (Graph 2). Over the period 2005 to 2012, the Eurozone became divided into two camps. Eleven economies show on average a twin deficit; while six economies have current account surpluses, but also a significant public debt to GDP ratio. In economic terms, France and Germany belong to opposing groups. Even though they both show on average similar public debt ratios, they differ significantly in regards to their current accounts, France being a debtor and Germany being a creditor. Moreover, whereas France is still dealing with budget deficits Germany was successfully achieving zero-budgets in 203 and 2014; also, its positive growth rate of GDP helped to reduce its debt ratio further. Those differing economic positions made economic policy cooperation between both sides to a difficult task.

Graph 2

Data: Eurostat

By defining a creditor economy as an economy with a structural current account surplus and an ‘acceptable’ debt ratio, we can see that the Eurozone divides nicely into a debtor-creditor continuum. However, not all creditor economies have sound financial positions[[13]](#footnote-13). Belgium for example, averages a small positive current account, but a substantial public debt ratio that is far above the ratio of Spain and Cyprus, and in the range of France. Even Germany has a much higher public debt ratio than for example Spain. Still, the current account is relevant as a surplus shows that even high debt economies are able to refinance. Graph 2 shows that the creditor club consists of Germany, Austria, Netherlands, Luxembourg, Finland, and Belgium. Given that at least three (Belgium, Austria, Germany) out of the six have public debt ratios above the Maastricht criteria, it seems reasonable to argue that governments of these economies have no interest in policies that result in a mutualization of debts. This is the same reason these countries are either opposing or are highly skeptical towards the quantitative easing policies of the ECB, as the risks involved with this policy potentially lead to huge budget burdens.

Based on those distinctions, France is in the debtor camp, even though this reality has not yet been accepted politically[[14]](#footnote-14). Accordingly, it would like creditor economies to provide fiscal stimulus as well as increase domestic demand via productivity-oriented nominal wage increases. Such suggestions did go nowhere nor did any French sympathy for instruments of debt mutualization. Unlike in the past, Germany now has more potential allies who are keenly interested in defending their national positions and prefer austerity to stimulus.[[15]](#footnote-15). In contrast, governments that favor a broad range of burden sharing programs, in particular forms of Eurobonds, are in a non-winning position. In the European Council such a cluster of deficit economies-governments could at best aggregate 125 votes. This is a far cry from the 255 votes needed to get a qualified majority. If governments would vote along the deficit-surplus axis, Germany would not need an alliance with France to enshrine its austerity approach to the EU. While not dissolved totally, the French-German axis is certainly downgraded in the ongoing crisis management. [[16]](#footnote-16) At the same time, Germany has now more options to find partners who are in support of its policy preferences, and this potentially brings France back in line. Moreover, time is on the side of Germany. During the relatively calm period between 2012 and 2014 where Ireland, Spain and then also Portugal left the support programs of the Troika and turned again – successfully - to private credit markets, the debate about the preferred crisis management of the Eurozone moved to the political margins[[17]](#footnote-17). In political terms, governments of the debtor camps invested heavily in austerity programs as well as in structural reforms that changed underlying social contracts in favor of capital.

*Unintended Consequences of National Preferences*

These shifts of power toward Germany do not portend a ‘Fourth Reich’. However, the Eurozone crisis, by forcing member states back to their national interests, has demonstrated that ‘Europeanization’ is more of an intellectual construct than a political reality. The recourse to national preferences, led by Germany, is guiding the reforms of European institutions as well as the crisis management of the Eurozone. The outcome so far is a paradox. On the one hand, the many reforms put in place since 2011 on the European level have drastically reduced national power in regards to budget policies (‘European Semester’; ‘Fiscal Pact’ ‘Debt Brake’…) and thus strengthened EU institutions. The guiding principles of these reforms, on the other hand, reflect policy preferences of the creditor club, particularly of Germany. The creditor camp so far made successfully use of this power shift in the deliberations in the European Council. Latter became the key institution in the ongoing crisis management.

However, policy coherence does not necessarily imply success. [[18]](#footnote-18) Germany’s supposedly coherent and rational crisis strategy has had unintended consequences that endanger the political, as well as the economic integrity of the overall currency project.

The Eurozone crisis has been accompanied from its very start by a debate about the economic rationality austerity. This debate has become increasingly heated, and moved beyond the economic policy arena. An influential ‘Harvard camp’ of economists proposed ‘expansionary contraction’ following the eponymous hypothesis of Giavazzi/Pagano (1990), Alberto Alesina and others to the effect that austerity even in times of crisis is the superior crisis policy. This proposition got additional political traction with the work of Reinhart/Rogoff (1999) and their now infamous 90% rule. The economic historian, turned intellectual pop star Niall Ferguson completes this camp of prominent ‘austerians’. The analytical and political views of this camp are mainstream; in the case of the German academic economic profession they are actually shared by 90% of mainstream economists[[19]](#footnote-19). Compared to this vast camp, proponents of an opposing view were smaller in number but louder in their voices, not least thanks to the tireless interventions of Paul Krugman and the like. Armed with insights of John Maynard Keynes, this camp argues that austerity involves a fallacy of composition. In the situation of a balance sheet crisis not all sectors of an economy can deleverage simultaneously. Given the high debts of the private sector it is crucial that that sector correct its balance sheet. The public sector needs to accompany these private sector corrections by accepting an increase in its debt ratio if a recession is to be avoided. In other words, austerity is a self-defeating approach under certain conditions. This view has received indirect support by research from the International Monetary Fund (IMF). Their research indicated that in situations of a liquidity trap, when central banks already operate on the lower bound for monetary policy, the government multiplier is much stronger than usually assumed. In other words, austerity works fairly quickly through the macro economy and generates negative growth effects.

The immediate effects of heavy front-loaded austerity programs seem to confirm these critical voices. By early 2012, twenty out of 26 member states were under the Excessive Deficit Procedure due to their violation of the 3% deficit-to-GDP criteria. In addition, The Eurozone has entered a recession, and particular economies like Greece, Spain, Portugal and Italy which have experienced severe and long-lasting austerity programs have also suffered from a corresponding shrinking GDP, and large increase in unemployment. Financial markets have carefully observed these developments, sometimes with fear but also as an opportunity to make political actors move. Over the period 2010 and 2012 it was the ‘stick’ of financial market actors that pushed political actors out of their procrastination and made them act.

Graph 3



Financial market actions resulted in ‘panic attacks’ that generated strong increases in the yield of government bonds from 2010 to the end of 2012. Political actors initially responded in small ways provoking further speculative attacks in a speculation-crisis response-speculation pattern that added to the overall uncertainty of the future of the Eurozone (Hübner 2012) Rather than overcoming the crises, the dominating austerity approach led the crisis economies into even deeper slumps and moved the overall Eurozone into a recession zone. Moreover, inadequate fiscal policies strengthened the role of financial markets that once again played their role as key evaluators of the crisis management responses, and were able to push governments to further action. The most relevant non-intended outcome of the austerity operations was the transformation of the ECB from an inflation-chasing central bank into a creditor of last resort for Eurozone economies. It was the disastrous effect of the misguided fiscal policy approach, in combination with the speculative attacks of financial markets that forced the ECB to unorthodox actions that went far beyond its mandate. In other words, the German-inspired austerity approach drastically transformed the institution that was supposedly designed as a clone of the Bundesbank.

Since the launch of the Euro, the ECB was seen as the institutional representation of trust, confidence and stability of the newly launched currency. Actually, gaining trust was the key goal of monetary policy actions at the ECB from its very start (Hübner 2002). In order to allow the ECB to follow through with its mandate, the bank was set up as a independent institution in the tradition of Western central banks. Given that the set-up of the mandate of the ECB was guided by German policy preferences, the bank can be seen as the agent that secures the policy mandate set by the principal. When the financial crisis of 2008 hit, the ECB consequently was slow to follow other central banks by executing a strongly accommodating monetary policy to support expansive fiscal policy programs. In particular the German representatives in the Governing Council of the ECB were eager to defend the inflation-fighting mandate of the ECB rather then accommodating expansive fiscal policies. Still, this policy decision was a far cry from the ECB’s policy turn in the further ongoing of the Eurozone crisis when Frankfurt had to turn to policies outside its narrow mandate. In a more superficial way one can argue that the real changeover came with the change in presidency from Trichet to Draghi, even though this policy change was not so much driven by the change in leadership than by functional requirements. In a situation when fiscal policy was confined by political constraints it was up to the only institution with potentially unlimited firepower to contain the spreading crisis effects, the ECB. In swift steps the ECB blew up its balance sheet and with its Outright Monetary Transactions program and the automatic stabilizer TARGET2 it was able to recreate trust on the side of financial markets. When Mario Draghi in June 2012 eventually declared that the ECB was willing to do whatever it takes to rescue the Eurozone, the bank became the ultimate guardian of the currency union. Since, the political struggle over the mandate of the ECB has intensified.

This policy turnover was met with harsh resistance from German central bankers, political representatives, professional economists, and even the public at large. Fairly quickly, Axel Weber, the unofficial German successor of ECB-President Trichet stepped down as president of the Bundesbank and thus as the unofficial successor of Trichet; this early retreat was also followed by the early retirement of the chief economist of the ECB, Jürgen Starck. Chancellor Merkel sent Jens Weidmann, her chief economic advisor and a former student of Axel Weber, to Frankfurt. He quickly turned into the most outspoken policy hawk and fanatically questioned and objected to all ECB action in regards to its new role as creditor of last resort. The Bundesbank expressed its dismissive position at a hearing of the German Constitutional Court on the legality of the European Stability Mechanism. In clear contradiction to Mario Draghi’s statement that the ECB would do whatever it takes to preserve the Eurozone, the Bundesbank stated:

 “Given that we still deal with sovereign nation-states, the current composition of the currency union can’t be guaranteed – at least not by the central bank. Hypothetically, this could only be done if the central bank would agree to unlimited lending in order to avoid that an economy leaves the union. Such an action, however, is not part of the mandate of monetary policy[[20]](#footnote-20)” (Bundesbank 2012)

According to the Bundesbank, the ECB went far beyond its monetary policy mandate and acted in a legal grey zone[[21]](#footnote-21). We can assume that Weidmann is at least as outspoken at the meetings of the Governing Council of the ECB as he is in his public statements. The Governing Council, consisting of the seventeen heads of national central banks plus the six members of the executive board, usually makes decisions by consensus. If we assume to some degree national policy narratives guide members of the Governing Council, and if we also take into consideration that each member has one and only one vote, then it seems reasonable to conclude that the German representative will try to build a coalition to support his position. Potential partners are heads of central banks of economies that belong to the current account surplus camp. Surplus economies are not eager to accept financial risks by instrumentalizing the ECB for the rescue of the Eurozone. However, it is obvious that Germany’s chances to block policies potentially favored by representatives of deficit economies are slim in a one-country-one-vote system. Public statements also indicate that the majority of the executive board, including German representative Jörg Asmussen at the time, favored the various easing programs of the ECB. Under these circumstances, Weidmann only could keep up the rhetoric and accept that he cannot form a coalition that would reverse the current policy of the ECB.

So far, the German government did not enter the fight over the mandate of the ECB.[[22]](#footnote-22)On the contrary, it seemed that the Merkel government was well aware that the ECB is the only institution that can prevent a breakup of the Eurozone under circumstances where the multilevel governance regime of the EU is seemingly unable to design a broad and adequate crisis management regime. Finance Minister Schäuble on the occasion of the Supreme Court hearing pointed out that ‘the federal government sees no sign that the measures taken by the ECB so far have done damage to its mandate”[[23]](#footnote-23). As a matter of fact, one can argue that the ECB acts as a strong ally of the Merkel government’s piecemeal strategy. The various easing programs of the ECB buy Eurozone government’s highly valuable time to move along their own political time axis, and to enact reforms that are enormously contested politically. Given that the ECB pushes as strong as Germany and other surplus camp governments for strict austerity policies in combination with far reaching structural reforms, in particular in the areas of labor markets and social policy, it is clear that Frankfurt and Berlin share common principles.

Mario Draghi rightly claims that so far it was the ECB that saved the day and avoided the breakdown of the Eurozone in a time of escalating panic (Draghi 2013). Avoiding the collapse of the common currency however, is not synonymous with solving the crisis. The latter needs much more than an unconventional monetary policy; in particular it needs coordinated government actions that deal with the roots of the crises. Moreover, the policy turn of the ECB is not without economic as well as political risks. Since late 2010 the bank has drastically extended its balance sheet and added low quality items to its balance (Yardeni 2015). The ECB started to engage in long-term financing operations and was actually bailing out troubled governments. This policy change coincides nicely with the turn towards fiscal austerity and the start of panic attacks on the side of financial markets. It became the job of the ECB to act as creditor of last resort by providing financial injections to credit-starved economies. The operations required from the Bank resulted in it accepting collateral of low quality in exchange for liquidity. Its balance sheet increased enormously, and so did the public concern over the quality of this steep rise in liabilities, an increase that was seen as a process that was turning the ‘good’ ECB into a ‘bad bank’. The German debates in particular characterized the OMT as a money printing exercise that had the potential for a huge rise in inflation rates[[24]](#footnote-24). Empirically, the opposite has happened. The average inflation rate of the ECB is slightly below the ‘target’ inflation rate; despite the growth of central bank money the credit channels for the private business sectors are still clogged.

The problem of the politics of quantitative easing are of a different nature and mainly have to do with the well-known problems of sending misleading signals to financial markets. Record low interest rates and huge purchases of government bonds are stimulating financial markets, and thus potentially could start a new asset bubble (Bank for International Settlements 2013). However, in a situation where national governments are politically hampered to design encompassing crisis management policies, the ECB has no alternative than to stay the course, even if this policy nourishes a new asset bubble.

National governments and the ECB have moved to a ‘bad equilibrium’. Governments see the reduced pressure from financial markets as a political opportunity to slow down the economically and politically painful restructuring programs; the ECB needs to stick to its deterrent approach while simultaneously keeping up its pressure on governments not to give in to ‘reform fatigue’.

*Cracks in Leopard Politics*

The German crisis approach may have emerged slowly and in a piecemeal fashion, but it never deviated from the basic policy convictions that were already put in place at the launch of the Euro and indeed long before it. What initially looked like a fundamental revamp of economic governance turns out to be a mere adaptation of long-established policy to new circumstances. The Stability and Growth Pact that Germany supported had already provided that violators of rules will be put under surveillance; this principle has been renewed and to some degree tightened in the course of the launch of various rescue facilities and programs. Moreover, the political acceptance of the violation of article 125 and the quiet acceptance of the transformation of the ECB into creditor of last resort appear to have strengthened the conviction that, in exchange for these concessions, debtors must make strong political and legal commitments that would prevent moral hazard. Thus, conditionality has become the key ingredient of the policy menu. This approach has been replicated by the ECB which required governments first turn to the emergency mechanism provided by the EU (see below) with its strong conditionalities, before the bank would consider engaging in government bond purchases[[25]](#footnote-25): “OMTs can be applied only if governments accept policy conditionality that leads to reforms. At the same time, it was the requirement of effective conditionality embedded in OMTs discourages governments and parliaments from requesting a programme unless strictly necessary” (European Central Bank 2013). It needs to be noted that so far not a single troubled bond has been purchased under OMT, and an actual test of this instrument is still lacking. Financial markets have been kept at bay since Draghi announced the willingness of the ECB to defend the Eurozone. It will be up of the further economic and political development of the zone if and when a practical test occurs.

What have been labeled as ‘structural reforms’ are a package of far-reaching changes of labor market institutions and practices, as well as welfare state programs that aim to decrease costs and add flexibility, and thus enhance competitiveness[[26]](#footnote-26). These policies are not new but have been an integral part of the potential adjustment buffers from the very start of the common currency (Hübner 2002). After all, members of a currency union lose the exchange rate policy as an adjustment mechanism and thus need to rely on flexible wage relations in order to deal with asymmetric shocks. In other words, in a world without the exchange rate tool, constrained national fiscal policy due to the Stability and Growth Pact, and unified monetary policy, the only remaining adjustment variable is the wage relation. It turns out that these structural reforms were mostly neglected by Eurozone economies.

From a macroeconomic perspective, the Frankfurt-Berlin consensus is self-contradictory. Austerity as the core of structural reforms is a self-defeating mechanism; government bond purchases by the ECB lift investor sentiment and contribute to asset bubbles. Asset bubbles in a low growth environment indicate the build-up of misallocation of resources, and thus work against the stability targets of austerity. In other words, the more austerity results in low growth and high unemployment, the more action is needed from the side of the ECB, and the more distant a new growth path becomes. The hesitant and overall inadequate policy response of national governments, and the Commission, puts the ECB in a difficult situation. The less governments of member states are coming up with adequate policies, the more the ECB needs to meddle in economic policy affairs, and thus to stretch the interpretation of its mandate. The purchase of government bonds helps financial institutions in their efforts to clean up their balance sheets, but does not prepare the ground to restructure the crisis economies, nor does it disentangle banking crises from sovereign crises. National governments and the ECB are trapped in a ‘bad political equilibrium’.

The emerging new economic governance seems to have moved authority from the national levels to Brussels, mainly to the Commission. A closer look shows, however, that most of the changes strengthened intergovernmentalism as the Council carefully guarded its vested interests and made sure to ‘call the shots’. From the start of the crisis management the European Council has confirmed its role as principal via its actions and by delegating tasks to the Commission. As Chang (2013:266f.) nicely summarizes: “…the potential for agency slack [by the Commission] was thwarted by the use of police patrols by the member states. Public letters with instructions for those constructing the legislation were continually used. In addition, more extreme versions were introduced with task force and intergovernmental treaty to re-intergovernmentalize legislation that could have been done within the context of the existing treaties and the community method”. The fear of losing national sovereignty and risking incalculable financial burden became the guiding principle for the makeover of economic governance.

This return of intergovernmentalism generally favors the creditor camp over the debtor camp. In particular, it implies a stronger role for Germany whose policy preferences have become the standard of the Eurozone. Lately, output legitimacy of those preferences has come under stress, in particular in the debtor camp. The enormous social and economic costs of the austerity approach not only led to social protest in debtor economies, but also concerns about the political and social limits of this policy. Former Commission President Barroso made the point that austerity “…is fundamentally right…but has reached its limits in many respects”. And he added:” A policy to be successful not only has to be properly designed. It has to have the minimum of political and social support”) (European Commission 2013). Lazlo Andor, EU Commissioner for Employment, Social Affairs and Inclusion, pleaded jointly with speakers of the European Parliament and the OECD for a drastic course change that would entail productivity-oriented wage increases, as well as the introduction of adequate minimum wages (Andor et al 2013). In its ex post evaluation of the 2010 arrangement with Greece, the IMF self-critically claimed that the social costs of front-loaded austerity programs were underestimated, and led to mistakes in the design of the overall program (IMF 2013). In a situation where the empirical underpinnings of austerity have already come under serious pressure with the so-called Reinhart/Rogoff affair (Hübner 2013) statements like the ones from Barroso and Andor, as well as the critical self-reflection by IMF staff can be read as attempts on the side of the agent to slightly modify the agenda of the principal. The Commission, in agreement with the Council, gave Spain and Portugal, as well as France, more time to deal with the deficit target; Germany started a charm offensive with Spain by offering an apprenticeship program for young Spanish workers that would result in 5000 (temporary) positions. In the greater scheme though, such decisions are cosmetic. The Council and in particular the German government are outspoken about their intention to stick to the basic principles of their crisis management, and are only willing to show some flexibility in regards to the interest rate and repayment period. What is currently only a minor crack in the established crisis management strategy, however, has the potential to become a political irritant. Pressure may come from two sides. Political pressure may arise from political changes in some of the debtor economies where anti-austerity parties increasingly gain support. Economic pressure may arise from the low growth-high unemployment- disflation triangle that has the potential of an ‘Japanization’ of the Eurozone.

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1. Thanks for extremely useful comments go to Radikha Desai. I am still responsible for all errors and analytical misjudgements. [↑](#footnote-ref-1)
2. One of many is Kundnani (2014) who sees Germany dominating Europe by strategically favoring a project of economic nationalism. [↑](#footnote-ref-2)
3. By sustainability, I mean the continuing viability of a high value added-growth area that combines social security (including high employment) and qualitative growth, as outlined in the Lisbon Strategy of the EU. [↑](#footnote-ref-3)
4. The emphasis is on ‘mainly’. There are numerous examples of struggles over influence and decision-making between the Council and the Commission, as well as between the Commission and individual member states. The most recent example is the controversy between the Commission and the French government. France was granted a two- year extension to conform to the criteria of the Excessive Deficit Procedure and the Council endorsed this. The French government, however, objected to the Commission’s inclusion of concrete reform proposals in its official report and even more to the suggestion that France speed up the reform process. The French Prime Minister, Jean-Marc Ayrault, responded by saying that while France was willing to reform, it would do so on its own political pace. The Treaty of Lisbon may have introduced principles like double majority and overall led to an increase of power in the European Parliament, and to some extent also upgraded the role of the European Commission, but in crisis, it was the European Council that took the lead and often bypassed the Commission and the EP. The Merkel government exercises its leadership in the Council. This paper argues that intergovernmentalism is back in force. The Commission can make proposals, but it is the Council that eventually decides about the way forward. Moreover, not all members of the Council are born equal. The politically weighted Council calls the shots, and it is the Commission that, while having some political leeway to express deviating views, eventually has to stick to the policy route commanded by the Council: it may be only a slight exaggeration to say that the Council is the principal, the Commission, the agent. The Commission is not without authority to act, but this authority is strongly constrained and in the course of the crisis dynamics increasingly contested. [↑](#footnote-ref-4)
5. A condensed overview is given by: <http://europa.eu/legislation_summaries/economic_and_monetary_affairs/introducing_euro_practical_aspects/l25007_en.htm> [↑](#footnote-ref-5)
6. Latter is a pleonasm as liberalism is another label for unrestricted competition. [↑](#footnote-ref-6)
7. The mechanism is well known. With the central bank of the anchor currency using its interest rate tool uncompromisingly to keep inflation low, higher inflation in other economies will suffer capital flight to the low inflation economy. The only way to prevent this will be to increase their key lending rate and risk a decrease in economic growth. [↑](#footnote-ref-7)
8. Frankfurter Allgemeine Zeitung; Süddeutsche Zeitung; Spiegelonline; Zeitonline. [↑](#footnote-ref-8)
9. This graph does not include the ‘Alternative for Germany’-Party (AfD). This new party is not represented in the German Bundestag but was successful in the European elections in May 2014. AfD is a right of the center party with a strong anti-Euro program. [↑](#footnote-ref-9)
10. Die Linke joined a rather heterogeneous group of individuals and organizations in a lawsuit over the legality of ECB actions (see below). [↑](#footnote-ref-10)
11. The EU Commission points out that France is relatively well positioned in high tech sectors, mainly aerospace, but has problems keeping up with competitors inside and outside the EU in activities that require steady innovative improvements (EU Commission 2013). [↑](#footnote-ref-11)
12. Even though France and Germany have enjoyed record low yields for federal government bonds since 2009, only for Germany did those they result in improved budget figures. Between 2009 and 2013, the lower interest rates translated into an aggregate saving of 80 billion Euros (Boysen-Hogrefe 2013). The more German bonds turned into safe havens for intra-Eurozone capital flight, the higher the benefit. While the Merkel government undoubtedly benefitted from the crises of member economies within the zone, c*ui bono*, this should not be confounded with causality. [↑](#footnote-ref-12)
13. The terms ‘creditors’ and ‘debtors’ are often used very loosely in public debates. ‘Creditors’ are perceived as nation-states with sound public finances and positive current accounts. In such a perspective not even Germany would belong to the camp of ‘creditors’ as its public debt ratio is far above the 60% Maastricht criteria. [↑](#footnote-ref-13)
14. My thanks go to Nicolas Jabko, who explained to me, in detail the unwillingness of France’s political elite to accept this status. After all, though French debt has been downgraded, the interest rate for French government bonds is at a historical low. However, such resistance will become more difficult when, with persisting competitiveness and unemployment problems, bond rates go up. [↑](#footnote-ref-14)
15. The most recent French-German plan for a separate president of the Eurozone should not be read as a compromise. The installation of a separate presidency may be close to the long-standing French demand of an ‘economic government’ but such a presidency would come on German terms. There is no reason to expect a turnaround of German principles. What can be expected, though, is more flexibility in implementing those principles and norms. [↑](#footnote-ref-15)
16. Vassallo (2013) and Gros (2013) are more optimistic about the policy relevance of the French-German axis. In my view, the governments of both countries seem to have more and more problems developing inclusive policies that are attractive for a large group of Eurozone member states. [↑](#footnote-ref-16)
17. The debate only came back after national elections in Greece early in 2015 when a Syriza-led government made the attempt to question the logic of austerity (see for live discussions [www.zausel100.wordpress.com](http://www.zausel100.wordpress.com)) [↑](#footnote-ref-17)
18. Chancellor Merkel’s response to a *Der Spiegel* interviewer who asked whether she had a grand scheme for Europe’s future is revealing: ’I really believe that it is reasonable and promising for us to work our way out of the crisis step by step, because the one overarching solution doesn’t exist. But, of course, you can only take these steps if you have an idea of the direction you are taking’ (Der Spiegel Online 2013). [↑](#footnote-ref-18)
19. This figure should not be taken too literally as it only represents a back-of-the-envelope calculation that is based on the ongoing debate. Often, the new party ‘Alternative für Deutschland’ is seen as the political party of academic economists. Be this as it may, the German debate is not at all about the macroeconomic rationality of front-loaded austerity. This recipe is widely accepted in the German profession. The debate is mostly about the legality of ECB politics (see below) and the best way to safeguard German interests in a dissolving Eurozone. [↑](#footnote-ref-19)
20. My translation. [↑](#footnote-ref-20)
21. Jörg Asmussen, previous German member of the Executive Board and close friend to Weidmann, recently gave a different view: “When we started this program [the OMT], the Eurozone was close to falling apart in an uncontrolled manner. At this time the ECB was the only fully operational European institution, and it was up to the ECB to demonstrate to speculators not to quarrel with the ECB. The Euro will be defended” (FAZ, 10 June 2013). [↑](#footnote-ref-21)
22. This does not hold for the coalition parties. CDU/CSU and to an even greater extent the Free Democrats, are very outspoken in their anti-ECB sentiments. Rainer Brüderle, head of the parliamentary faction of the FDP at the time, wrote a letter to Mario Draghi and demanded that the ECB president personally represent the ECB in the Supreme Court hearing about the legality of the ESM, and the bond purchase program of the ECB. [↑](#footnote-ref-22)
23. See Financial Times, 13-06-2013, 8:46 AM. As a trained lawyer Schäuble chooses his words carefully and qualifies this statement by using ‘so far’. [↑](#footnote-ref-23)
24. Jens Weidmann used the Goethe festivities in Frankfurt in September 2012 for a fundamental statement on the responsibility of central banks in dealing with permanent political pressures, and of the temptation for governments to ask for the monetization of public deficits. “If central banks can potentially create an unlimited amount of money out of thin air, how can we ensure that money remains scarce to preserve its value?’ asked Weidmann. His answer is straightforward: ‘…central banks were subsequently established as independent institutions, with the mandate to safeguard the value of money, in order to explicitly keep the government from co-opting monetary policy’ (Deutche Bundesbank 2012). – The hearings at the Constitutional Court in June 2013 were an impressive documentation of the dominating intellectual debate among German academic economist. The vast majority of these economists argued that the ECB is violating article 123 and operates a policy that comes with high risks in terms of potential inflation, and public debt increases for Germany. [↑](#footnote-ref-24)
25. Draghi labeled this as the ‘two-pronged approach’ where any ECB action on secondary markets depends on the willingness of debtors to accept strong conditionality. [↑](#footnote-ref-25)
26. The Economic Adjustment Program (EAP) contained within the agreements which countries that moved under EU umbrellas signed onto, includes many more items, in particular concrete changes to established tax regimes. The core element of the EAPs is structural reform in labor markets and all aspects of welfare states. [↑](#footnote-ref-26)